

POLICY RESEARCH WORKING PAPER

wps 2723
2723

Using Development-Oriented Equity Investment as a Tool for Restructuring Transition Banking Sectors

Helo Meigas

Development-oriented equity investment, undertaken in the context of World Bank projects, can assist in promoting sound banking systems, especially through its positive impact on bank governance. This was the experience of Swedfund Financial Markets that made equity investments in banks in the Baltic republics of Estonia, Latvia, and Lithuania.

The World Bank
Europe and Central Asia Region
Private and Financial Sectors Development Sector Unit
November 2001



Summary findings

Over the past 10 years the three Baltic republics have undertaken significant restructuring of their banking sectors, supported by the World Bank through three projects: the Financial Institutions Development Project in Estonia, the Enterprise and Financial Sector Restructuring Project in Latvia, and the Enterprise and Financial Sector Project in Lithuania. These projects included a credit line, channeled through local commercial banks, to provide long-term funding and complementary technical assistance to private enterprises. In parallel, the government of Sweden injected equity into the commercial banks from Swedfund Financial Markets (SFM). The projects and the accompanying Swedfund equity were aimed at promoting sound banking systems in the three Baltic countries—by strengthening the equity in the banks and thereby expanding medium- and long-term financing.

Meigas examines the role of SFM—which provides development-oriented equity investment (DEI) to Baltic banks—in the context of the World Bank programs. She examines the arguments for deploying DEI as a development vehicle by gauging its impact in the three Baltic countries on banking skills and services, on capitalization, and on shareholder structure and board membership. She draws out the role of technical assistance and compares its impact with that of DEI, and explores the possibilities offered by DEI for imposing sound corporate governance. The author also describes the necessary ingredients for successful DEI.

The author's analysis shows that the Baltic projects were valuable initiatives that could in principle be replicated in other transition or developing economies whose banking sector faces serious restructuring challenges. A development-oriented equity investment, like that made by SFM, can address the important deficiencies in a banking sector that is still in a rudimentary state, lacking both capital and banking skills. SFM's most effective tool was the imposition of sound corporate governance on the institutions that received the equity injection. This approach provided a powerful supplement to the banking supervisory functions. Rather than relying on the external enforcement power of state supervision, SFM targeted internal processes to change business practices. As a result, the DEI led to improvements in the corporate culture and broader risk management and thus in the quality of banking services—not only meeting the institutional development objectives but also ensuring an adequate return on the invested capital.

The potential of good corporate governance for easing the work of banking supervisors has been stressed by the Basle Committee on Banking Supervision. This potential is particularly valuable in countries still developing the supervisory function, and DEI, the author argues, is well suited for the task of improving corporate governance.

This paper—a product of the Private and Financial Sectors Development Sector Unit, Europe and Central Asia Region—is part of a larger effort in the region to disseminate the results of successful policy initiatives in the financial sector. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Sylvia Torres, room H6-216, telephone 202-473-9012, fax 202-522-0005, email address storres@worldbank.org. Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The authors may be contacted at helo_meigas@mckinsey.com. November 2001. (23 pages)

The Policy Research Working Paper Series disseminates the findings of work in progress to encourage the exchange of ideas about development issues. An objective of the series is to get the findings out quickly, even if the presentations are less than fully polished. The papers carry the names of the authors and should be cited accordingly. The findings, interpretations, and conclusions expressed in this paper are entirely those of the authors. They do not necessarily represent the view of the World Bank, its Executive Directors, or the countries they represent.

**USING DEVELOPMENT ORIENTED EQUITY
INVESTMENT AS A TOOL FOR
RESTRUCTURING TRANSITION BANKING
SECTORS**

By Helo Meigas

TABLE OF CONTENTS

EXECUTIVE SUMMARY	I
I. INTRODUCTION.....	1
II. BUILDING THE CASE FOR DEVELOPMENT ORIENTED EQUITY INVESTMENTS.....	2
Assessing the level of banking skills	3
Determining the capitalization of the banking sector	5
Where can technical assistance have the best impact?	6
How can corporate governance help where technical assistance fails?	8
III. THE INGREDIENTS FOR THE SUCCESS OF A DEI.....	12
Establishing partners	12
Building an appropriate organizational structure.....	14
Determining an adequate environment for investment	19
IV. CONCLUSION.....	21

ABBREVIATIONS AND ACRONYMS

DEG	German Aid Agency
DEI	Development oriented equity investment
EBRD	European Bank for Reconstruction and Development
EU Phare	European Union Assistance program for Eastern
FMO	Netherlands Finance Company for developing countries
NIB	Nordic Investment Bank
SFM	Swedfund Financial Markets
TA	Technical Assistance
WB	World Bank

Foreword

The Baltic Republics have gone through a remarkable process of transition over the last ten years, not least in their banking sectors where each country has essentially had to start from scratch. Banking systems as we know them in the West simply did not exist prior to 1990.

Banking transition has, as a result, been a long and bumpy road. Progress has often been punctuated by banking crises that has set the financial sectors back. But significant progress has nonetheless been made and foreign investors have recently shown confidence in the emerging banking systems by taking major equity stakes in banks in all three countries.

The Baltic countries have been aided in their financial transition by the International Financial Institutions, by the European Union and by a large number of bilateral donors. This paper examines the experience of one quite unique partnership in the banking area, that between the World Bank and the Government of Sweden.

During the mid 1990s the Bank prepared financial sector projects in each of the three Baltic Republics, aimed primarily at the restructuring and institutional strengthening of the banking sector. The Bank was partnered by the Government of Sweden through the establishment of Swedfund Financial Markets, a development oriented equity fund structured to invest in emerging Baltic banks.

The overarching question that this paper seeks to address is how successful was that partnership in reaching its goal of facilitating a restructuring and strengthening of the Baltic banking sectors. To obtain objectivity in making this assessment the Bank and the Government of Sweden engaged Helo Meigas—former Deputy Governor of the Bank of Estonia—to undertake the study. She has seen the results of the Bank's work, and that of Swedfund, from the special perspective of a recipient country. The Bank and the Government of Sweden are very grateful for the extensive research that has been undertaken by Mrs. Meigas and for the high quality of the analysis that is reflected in the paper that follows.

Alexander Fleming
Europe and Central Asia Regional Office
World Bank, Washington DC

EXECUTIVE SUMMARY

Significant restructuring has taken place in the banking sectors of the Baltic Republics over the past ten years. This was supported by the World Bank in the context of three projects: the Financial Institutions Development Project in Estonia, the Enterprise and Financial Sector Restructuring Project in Latvia, and the Enterprise and Financial Sector Project in Lithuania. These projects contained a credit line, channeled through local commercial banks, to provide long-term funding and complementary technical assistance to private enterprises. In parallel with the credit lines was an equity injection into the commercial banks from the Government of Sweden Swedfund Financial Markets (SFM). The aim of the projects, and the accompanying Swedfund equity, was to promote a sound banking system in the three Baltic countries through strengthening the equity in the banks in order to produce a larger volume of medium-term and long-term financing. The purpose of this paper is to examine the role of SFM – which essentially provides development oriented equity investment (DEI) to Baltic banks – in the context of the World Bank programs.

The analysis in the paper illustrates that the projects were very valuable initiatives, which could in principle be replicated in other transition or developing countries where the banking sector is facing serious restructuring challenges. A DEI, like that made by SFM, is well positioned to address the very important deficiencies in a banking sector still in a rudimentary state, lacking both capital and banking skills. SFM's most effective tool for achieving the development objectives was imposing sound corporate governance on the institutions that received the equity injection. Such approach enabled to provide a powerful supplementary tool to the banking supervisory functions. Instead of using external enforcement power of state supervision, the internal processes were targeted to achieve change in business practices. As a result, improvement in corporate culture and broader risk management was achieved, leading to the significant improvement in the quality of the banking services. This enabled not only the institutional development objectives to be met but also an adequate return on the invested capital to be earned. The potential of good corporate governance in making the work of supervisors easier has been stressed by the Basle Committee on Banking Supervision. As such, it is even more valuable in countries, where the supervisor function is only developing and DEI as a vehicle is well suited for this task.

The first part of the paper examines the arguments for deploying DEI as a development vehicle. It addresses this issue through gauging the impact on the level of banking skills and services in the three Baltic countries. The impact on the level of capitalization as well as shareholder structure and board membership is also described. The role of technical assistance (TA) and its limitations vis-à-vis a DEI are drawn out. Finally, the possibilities that DEI bring for imposing sound corporate governance are explored.

The second part of the paper describes the ingredients needed to achieve success in a DEI. First, the DEI partners, like the donor country, other assistance projects, multinational or bilateral public equity investors as well as the host authorities are discussed. Secondly, the importance of appropriate organizational structure in adopting a commercial approach into managing the investment is analyzed. Thirdly, the elements of a suitable environment for a DEI are discussed.

I. INTRODUCTION

1.1 Since re-establishing independence in 1991, the Governments in all three Baltic Republics moved rapidly to break up the Soviet banking system. A large number of new private banks were licensed and banking supervision functions within the central banks were established. But despite that, even in 1994, the banking sector was still in very rudimentary stage. A significant proportion of banking sector assets were still state owned and foreign presence was very limited. The state owned banks, if accounts were compiled in accordance with International Accounting Standards, would have been deemed insolvent. There was a severe shortage of modern banking skills in credit risk assessment and asset liability management as in the planned economy banks acted as fiscal agents and not as independent allocators of resources. The banks' capital bases were too small to support the rising demand for credit from the enterprise sector.

1.2 In order to address these issues the World Bank (WB), in partnership with the Government of Sweden, initiated three comprehensive projects in the banking sector of the Baltic countries over the period 1995-1999. The Financial Institutions Development Project in Estonia, the Enterprise and Financial Sector Restructuring Project in Latvia, and the Enterprise and Financial Sector Project in Lithuania all included a credit line channeled through commercial banks to provide long-term funding to private enterprises. Supportive technical assistance programs were also provided. These projects were accompanied by equity injections from a Swedish Government fund--Swedfund Financial Markets (SFM). The aim of the projects was to promote a sound banking system in the three Baltic countries through strengthening the equity in the banks in order to catalyse a larger volume of medium-term and long-term financing. SFM was to focus the support on private banks or state banks under privatization, both of which in principle should qualify for loans from the WB. The equity contribution was planned as a start-up support which would gradually be replaced by capital infusions from the private sector.

1.3 This paper aims to assess the impact these three projects have had on the development of the banking sector in the Baltic countries and assess the extent such partnerships could be replicable in other countries. The paper analyses how such a development oriented equity investment, by imposing sound corporate governance, can yield results which are superior to a regular technical assistance support and the paper lists issues that need to be addressed in order to achieve such an outcome. The experience gained in the Baltic countries through the SFM experience points to the potency of this innovative development instrument, which has a potential to make a sustainable impact in the banking field in other developing or transitional economies.

1.4 For the purposes of the study, the Bank Staff Appraisal Reports and the Implementation Completion Reports for all three projects have been studied. Site visits were made to the three Baltic countries to meet with the representatives of the banks which received the equity injection and the credit line. Meetings also took place with the authorities responsible for banking sector development in the Baltic states. In addition, staff of SFM and the World Bank, as well as the representatives of the Government of Sweden, were interviewed.

II. BUILDING THE CASE FOR DEVELOPMENT ORIENTED EQUITY INVESTMENTS

2.1 When a country is moving from central planning to a market economy, it faces a vast array of structural reforms that must be undertaken. In order to support the reform process, assistance projects were typically initiated both by multinational organizations as well as through bilateral arrangements. Given the central importance of financial sector reforms, significant development work is always undertaken in the banking sector, mostly in the form of technical assistance given to the authorities for putting in place the needed legal and regulatory framework. But a more innovative approach—making a development oriented equity investment (DEI) in combination with other initiatives—should doubtless be given more prominence (see Box 1 below). The experience gained in the Baltic countries with the World Bank credit lines (see Box 2 on following page), which were combined both with equity investment from a donor country and TA from various sources, allows one to conclude that such combinations can be highly successful.

Box 1. What is a development oriented equity investment (DEI)?

A DEI is a hybrid instrument in that its objectives are simultaneously developmental while seeking to ensure a reasonable return on the investment. In the case of the SFM, the development goal was to foster the institutional development of the recipient's banking sector—but the means was through a venture capital approach using private market specialists as managers. A DEI would be expected to yield an adequate return for the investor which simultaneously attaining its development goals. The tolerance for loss would however likely be higher in a DEI.

2.2 In order to see the impact a DEI can have in an emerging banking sector, it is important to note that the banking sector at the initial stage lacks both the capital as well as the skills for its adequate development. Capital is essential for increasing the volume of financial intermediation. Typically the volume of such intermediation, in relation to the size of a transitional economy, is well below that in the western economy of equivalent size. Skills are critical for controlling the risks that come with increasing business volumes. Providing technical assistance through making available experts in different areas may not be the most efficient and direct way of handling these deficiencies. TA is valuable to the financial authorities in establishing the regulatory environment, but if there is a weak banking supervisory authority it is very hard to change business practices. The advantage of a DEI is that it brings the capital and the skills through imposing corporate governance as a tool for initiating and implementing the changes from within the banks. The rest of the section of the paper examines in more detail why a DEI can be a superior development instrument in transitional economy banking sectors.

Box 2. World Bank credit line facility

In 1994 financial sector development projects were initiated by the World Bank in all three Baltic states. In their detailed structure the projects differed slightly from country to country but the general objective was the same for all of them - strengthening the banking system. The credit line facility was designed to deliver finance to support the development of private and privatized enterprises, by providing financial resources through qualified participating banks for medium-term loans to private enterprises. TA was designed to complement the credit line in order to improve the capacity of both the banking system to deliver such resources, and of enterprises to prepare plans to secure them. Banks underwent comprehensive and tailored institutional development programs and had to undertake audits in accordance with International Accounting and Auditing Standards. The equity component was included in the project to increase the capitalization of the banking sector, providing therefore the own funds necessary for the growth of the loan portfolio.

Within the framework of the Financial Institutions Development Project USD 10 million was allocated for Estonia. For Latvia, under the Enterprise and Financial Sector Restructuring Project a USD 35 million loan was approved. Lithuania, meanwhile obtained the Enterprise and Financial Sector Assistance Project of USD 25 million.

Special units were established in each country with a responsibility to select banks that would qualify for the credit line, conclude subsidiary loan agreements with them, and authorize loan disbursements. In some cases funds had been made available also from other donor countries to finance the work of those specialized units. In Lithuania, the Apex unit was established in the Bank of Lithuania to act as a credit line manager, educating local bankers in the credit and risk analysis procedures. It also managed a twinning arrangement between Lithuanian banks and banks from Western Europe. In Latvia, a Technical Unit was established, which in addition to its main functions, played an important role in providing more general financial sector advisory services and in monitoring the banks. In Estonia, the Project Implementation Unit under the Ministry of Finance, did not play a significant role. But the Core Advisors Group, compiled under the auspices of the WB credit line, provided extensive institutional development support by offering assistance and advice to all the banks which sought their guidance.

The results of the credit line were different for each Baltic state. In Estonia, only one sub-loan was financed from the credit line. The last disbursement for the loan was made on February 1997. The bulk of the credit line, USD 7.7 million, was cancelled in July 1997 upon the request of the Government of Estonia. The Implementation Completion Report for Estonia recognized that the momentum for the credit line had passed. Increased activity of EBRD in the country and the acquisition of a rating from the international rating agencies provided banks with access to private markets, which were providing funding at better rates and easier terms.

In Latvia and in Lithuania the credit lines were also structured to provide (in addition to investment loans) working capital loans to companies which suffered from the lack of liquidity during the banking crises. As the banking sector weakened in Latvia and Lithuania, and eventually went into a severe crisis in 1996, there was a need for assistance to address the insolvency of the state-owned banks and the distress experienced by a number of the remaining large state-owned enterprises. By the end of the project all funds were disbursed and the Implementation Completion Reports for the projects have evaluated the credit lines to be highly successful in reaching a substantial number of enterprises. In Latvia, five commercial banks were participated and made a total of 303 commercial loans to their clients. Of the total disbursements, 61% was for project finance purposes, 39 % for working capital purposes. The average sub-loan maturity was about three years. In Lithuania, three banks were used to make loans which benefited a total of 40 companies.

Assessing the level of banking skills

2.3 Within a centrally planned economy, there were virtually no modern banking skills. When building market-based banking everything had to be developed from scratch: through the privatization of the whole or parts of state owned banks, by supporting the establishment

of new private banks, and by encouraging the entrance of foreign banks into the local market. It is only in the case of foreign banks, where the skills to run a banking business are made immediately available together with the capital, that skills can be embedded quickly. But the impact the establishment of a foreign bank would have on the local banking market in early years, was in practice very limited¹.

2.4 Banks, as providers of trade finance in their early stage of financial transition, initially grew out of the industrial sector, where the logic of running a business was very different from the knowledge needed in financial intermediation. The management of banks consisted of either recent graduates with no work experience, or an older generation who had general managerial expertise but very little knowledge about risk management in a financial institution. The banking knowledge was not much better at the board level² and as a result very little guidance was available from the shareholders. The majority of the board usually consisted of the top managers of the clients (i.e. industrial sector), who were invited onto the Board by the bank's management in order to keep the cash-flow of that enterprise within their bank only. Sometimes Board members were politicians or civil servants who were either connected to a big industrial group or, because of their position, were able to direct the flow of public funds. Their ability to assess the adequacy of the management decisions, and the level of competence involved in making decisions related to banking specific issues, was limited.

2.5 Although there was much learning-by-doing, the level of experience and knowledge within banks took time to develop. There was very little term lending undertaken. Instead funds were provided for trade finance based on the resale of Russian commodities and metals, which were priced below international levels (i.e. there were significant price distortions). Even in the cases where the banks felt relatively secure about the long-term credit risk of the loans, the loans were structured as short-term loans which were rolled over with renegotiated interest rates. Even if credit lines from multinational agencies had been provided, there was a general lack of demand for such lending.

2.6 Thus the nature of banking business in the early days of transition did not motivate the management of banks to either train themselves, or their employees, in the basic skills of credit risk analysis and project evaluation. It was only when large scale price distortions had been eliminated and businesses started to search for more long-term projects, that term lending began to grow. Unfortunately, the problems inherent in this type of loan would

¹ At the outset there were only very few foreign bank representative offices opened in the Baltic countries, none of which was licensed to offer banking services. In Lithuania, three state owned banks, 25 commercial banks (all locally owned and only 8 of them could be characterized as active banks) and a development bank had been established. State owned banks accounted for nearly 50 % of the market share. In Latvia, the previous branch network of the Soviet Specialized Bank, was unified into one bank (Unibanka) to be privatized with some branches to be sold to private banks. The state owned Savings Bank held the bulk of household deposits. The private banking sector, which was holding 77% of the total banking sector assets, was dominated by a few large banks. There was also a large number of very small banks, established as captive funding devices for state enterprises. In Estonia, the banking sector consisted of 18 commercial banks, two state owned banks (of which the Savings Bank was 67 percent state owned) and a development bank. The firm reaction of the Government to the banking crises in late 1992 had had a positive effect on the sector, but deposit accumulation was still slow (This is as it was seen during the time when the Staff Appraisal Reports for each country were compiled (see references).

² In all three countries, for the joint stock companies, the corporate law envisages a separate supervisory board and the management board with no overlapping members. For the purposes of the present paper, the supervisory board, as the highest governing body of a company after the shareholder's meeting, is called the board, and the management board, which consists of executive members only, is referred to as the management.

become evident only a few years after it had been granted. And in those years it was often the case that a rapid growth from a very low base would lead to a prolonged boom period, when excessive risks were taken without any concern about the potential threats that might arise during a recession period. Only when real losses start to occur would management start to understand the importance of credit risk analysis and project evaluation skills.

Determining the capitalization of the banking sector

2.7 In an emerging market economy the legal, regulatory and supervisory framework is in need of development from first principles. Both the general accounting laws and the banking specific legal acts that would enable an assessment of the value of assets correctly, and record all the liabilities appropriately, are inadequate. Also the auditor's profession is only just evolving. As a result it is very likely that the value of a bank's capital is not truly recorded in its books.

2.8 Because of limited banking skills, the judgments banks make about the creditworthiness of its borrowers are often wrong. Problems arise when banks fail to recognize impaired assets, do not create reserves for writing off these assets, and do not suspend recognition of interest income. Often it is not intentional misrepresentation to the supervisors and shareholders, but more due to the lack of appropriate management information systems that would give details on the conditions of the loan portfolio. The lack of liquidity in the markets makes the valuation of collateral very difficult. There is also a lack of skills in assessing the value of impaired loans, as well as an inadequacy of the regulations that prescribe the size of loan loss reserves. As a result, it is very likely that during these periods the value of banks assets is not adequately recorded in the books and that the loan-loss provisions are not sufficient to absorb the future losses from the loan book.

2.9 Credit risk in the loan portfolio is not the only source of misrepresentation in the balance sheet. The market risk in the trading book is not often accurately recorded because stock markets in their early stages are illiquid and volatile. The regulations that would require daily marking-to-market are often inadequate, giving banks the possibility to leave the losses from changes in stock prices unrecorded. Off-balance sheet exposures are left unrecorded and no capital is held against the contingent risks they retain. The regulation recognizing the links between different parties is insufficient and, as a result, large exposures are not properly recorded and capital is not allocated to these specific risks.

2.10 The standard of accounting and auditing work in emerging markets is not comparable to that in western countries. Some of the deficiencies are objective, resulting from the problems in evaluating the assets and recording the liabilities, as noted above. In addition, a significant shortcoming is the lack of experienced accountants and auditors. Like the banks themselves, accountants and auditors are also still learning their profession. A proof of that are several examples of banks in the Baltic Republics that had been closed by the authorities due to excessive risk taking. The report of the temporary trustee, which had been made for the bankruptcy court, had often shown the bank to be deeply insolvent not only as a result of those specific risks that had caused the closure, but also because of the misrepresentation of the value of certain assets or the existence of some unrecorded liabilities. That is why in these

early years, when the auditors' profession is still evolving, more caution is warranted in relation to the audited accounts.

Where can technical assistance have the best impact?

2.11 Giving assistance to the financial authorities is the most widely used form of TA, as the knowledge among government officials about the operations of the financial markets is very low. In the Baltic countries, a wide range of TA projects were initiated with help from various sources³. In areas with a direct impact on the banking sector, TA encompassed help in drafting new accounting, commercial and central bank laws. Work in non-banking areas also contributed to sound banking, like improvements to bankruptcy legislation and on developing collateral legislation for both movables and immovables.

2.12 The role of the World Bank projects in the TA to governments was primarily that of a coordinator. The WB staff preparing the projects coordinated with several other agencies operating in the region, trying to ensure that there was complementarity with no overlapping of responsibilities. If necessary, additional TA in issues that had been neglected by other donors was provided by the Bank. Because in some countries preconditions were set prior to their launch, the WB projects also managed to act as motivators, persuading the governments to work more actively in certain areas. In Latvia, the administrative procedures for bankruptcy legislation and public access to registers, titles and rights of commercial entities were implemented under the Project. The law on collateral and loan security was delayed, but submitted finally in 1998. In Lithuania, the policy actions requested as a precondition included enactment of new banking legislation, a program to strengthen banking supervision and an enactment of a scheme to phase in tax deductibility of bank loan loss provisions. In Estonia no specific preconditions were set by the WB project, but assistance was given by different agencies to the drafting of a new accounting law, on the work on land registries and on bringing the commercial banks' accounting and reporting in line with internationally accepted standards. In all three countries the project insisted on the introduction of audits of banks in accordance with International Accounting and Auditing Standards and in the preparation of the accounts of banks in accordance with these standards.

2.13 Typically there was only a few technical assistance programs that were directed towards the banks themselves. Out of the several initiatives undertaken in the TA area, the more long-term projects--where the confidence and trust can be built between the parties--were found to be most useful. Efficient and comprehensive institutional development was sometimes implemented in the form of twinning programs, financed by EU Phare and bilateral donors. These allowed not only provided advice to the banks on appropriate regulation, but also worked closely with them on implementation issues. One proof of the success of twinning arrangements was the fact that several banks, at their own initiative and expense, continued co-operation with the twinning partner long after the program had ended. The WB projects in the Baltic Republics had recognized the need to give TA directly to the borrowing banks, and the success of its TA initiatives should be attributed to the fact that the programs were specifically designed to reach the banks themselves. In the evaluations of the

³ The main providers of TA in the Baltic countries financial sector restructuring projects have been, in addition to the Swedish Government, the Governments of Denmark, Netherlands, Canada and Norway, EU-Phare, USAID.

WB projects, the TA provided over the lifetime of the project had been assessed as meeting the needs of the banking sector⁴. Most of the work with the banks was done through the special units that were established to manage the credit line part of the project (See also Box 2).

2.14 In Estonia, a Core Advisors Group--established under the World Bank projects--was working directly with the banks. Being on site for two years, and having the necessary expertise, it was able to make banks implement new internal regulations that were more comprehensive than what at that time was required by the regulators. Effective TA was given to the banks in credit analysis, internal audit and treasury operations. In Latvia, the Technical Unit worked closely with several banks in assisting them to design and implement credit analysis procedures and practices. The most success was achieved with the detailed TA given to Unibanka, which was a formerly state-owned bank with the largest market share in Latvia. This TA included significant institutional development support and assistance in its privatization process. In Lithuania the Apex unit was mostly focused on teaching the banks to prepare projects for the WB credit line but ABN AMRO, Unibank/ING and Norwegian Banking Resources worked directly with the banks.

2.15 In addition to the TA given by those special units, much effort went into the disbursement of the credit line. There was considerable interest in the credit lines during the banking crises in the Latvia and Lithuania, when the liquidity in the banking sector was very low because of the loss of confidence among businesses. During this period the conditions of the credit line (in Latvia) were changed to provide working capital loans as well as investment loans. After the banking sector had stabilized, medium-term funds had become available from EBRD and private parties. The WB credit line, because of its pricing as well as the complexity of its procurement procedures, was not attractive to banks any more. The question may be asked if, when the market failure in that sense did not exist any more, the example of Estonia should have been pursued, where the credit line was cancelled. Only if the spread and/or the fees from the lending activity are necessary to cover the costs of the consultants working on-site, is the continuation of such lending activity justified.

2.16 There were several beneficial side-effects of having a credit line in place. Firstly, it served as a motivation to the banks to receive and implement the TA that was set as a precondition to the disbursement of the funds. In the Baltics, to qualify as a participating financial intermediary, banks underwent comprehensive and tailored institutional development programs. Secondly, the learning process in preparing sub-projects for final borrowers of the credit line, was evaluated as useful by the banks. The application procedures to obtain sub-loans caused banks, after initial complaints about difficult procedures, to improve their credit and risk analysis procedures by developing and implementing advanced analysis methods for project evaluation. Thirdly, the information that was gathered during the due diligence process when the banks were evaluated against the pre-set criteria, and during monitoring the banks throughout the credit line life-time, was considered critical by the SFM in doing its own equity investments (see the discussion of it in Chapter 2). Fourthly, the

⁴ The Implementation Completion Reports prepared by the World Bank to analyze the outcomes of the projects found the work done to strengthen the banking sector, especially the institution building aspect of the three projects highly successful and sustainable. The report for Estonia has been issued in November 1998, for Latvia in March 2000 and for Lithuania in February 2001.

qualification for the WB credit line served as a quality stamp, which at the stage, when the banks were not rated by international rating agencies, helped them to access private markets.

How can corporate governance help where technical assistance fails?

2.17 Substantial amount of TA work is usually directed towards increasing the efficiency of the supervisory agencies. Unfortunately, very often the results will take a long time to be seen. The primary reason is the complexity of the work of the banking supervision function. The fact that supervision is always a public service, which typically gets paid under the civil servants salary scale did not help to attract talents into this line of work. That is why targeting improvements in corporate governance should be used to assist the supervisors. Inherently, the interests of the shareholders, which aim at earning an adequate return on their investments, are the same as the objectives of the supervisors. Only with adequate risk management, which is essential for running sound banking operations, can the viability and long-term profitability of the business be assured. There needs to be an understanding at the shareholders level about the relevance of the regulations and the urgency of implementing the necessary internal control systems. Without that, the work of the supervision is very difficult, if not impossible. Unfortunately, as discussed earlier, the necessary banking experience is very scarce on the board level in a locally owned bank.

2.18 It is only in recent years that more emphasis has been given to corporate governance issues. In a recent paper “Enhancing Corporate Governance for Banking Organizations” issued by the Basel Committee on Banking Supervision it is stated that supervisory experience underscores the necessity of having the appropriate levels of accountability and checks and balances within each bank, as sound corporate governance makes the work of supervisors infinitely easier. It is even more important when the supervision function is weak and not trusted by the banks.

2.19 When looking at the elements of good corporate governance in more detail, one can easily find reasons why its level is low in an emerging banking sector. Establishing strategic objectives and a set of corporate values for a bank is not always a priority issue at the stage when all the management time is devoted to day-to-day client relationships. This is especially the case when there are profit opportunities in vastly unregulated markets with high price distortions, and when concepts like conflicts of interest and arm’s length principle are not recognized. Setting and enforcing clear lines of accountability and responsibility is difficult when the number of knowledgeable people is limited and when any system of control is regarded as a demonstration of mistrust. The idea that the board is ultimately responsible for the operations and financial soundness of the bank is hard to promote when legal acts have defined their duties to be very general and management is not eager to share any of the powers, making instead every effort to keep the board away from information and the strategic decisions. Often this results in the board not being comfortable in questioning the management, which has been able to make itself seem indispensable to the survival of the bank. The importance of the audit function (both internal and external) is not always clear, especially to the management who, as they have been running the bank since its establishment, feel that they have a full knowledge about the bank, its operations and financial situation. The compensation and the bonus system of the senior management is often not consistent with the bank’s financial results and objectives, and the board does not

feel strong enough to interfere because of the fear of loosing the management. The issues of transparency and keeping banking secrets are deliberately interpreted as being in conflict with each other, so very little information is given out from the bank.

2.20 The experience in the Baltic countries, with corporate governance implemented in part by the SFM, serves as a good opportunity to learn about what can be done by a knowledgeable minority investor and also about issues where additional support from the outside is needed. It is quite evident that after a strategic investor had become a shareholder, further changes are made because of the greater control a strategic investor enjoys over the activities of the bank. That is why, when analyzing the achievements of SFM and other financial investors in a pre-strategic investor period, the difficulty of the task they were facing should not be underestimated. It is especially in the early stages of development when the shareholder structure is weak, and the interests of different shareholders are not in line with each other, that the management has full control not only of the bank's day-to-day business but also of its strategic decisions. Any interference from the shareholders is considered a sign of hostility and treated as such. Even sharing more detailed information about the financial positions of the bank may be considered as a first step towards giving away that independence. That is why for a board member not only the deep knowledge in the banking issues is necessary, but persistence and perseverance are equally important. All this was also relevant in the case of the SFM investments.

2.21 SFM representatives had a seat on the board of almost all the banks where it had made an investment. At the times when SFM had been an investor there were several areas where significant progress was achieved. Firstly, achieving systematic and open communication with shareholders-- both on the board meetings as well as through public disclosure--was a major step further (the publication of detailed annual accounts was also a result of the improvements in the securities market regulation). Information provided by the management to the board grew in its complexity as the knowledge within the board itself increased by having representatives of foreign investors like SFM and the EBRD as members. Significant progress was made in increasing transparency in the shareholder structure, including the disclosure of financial interests of the management. Major emphasis had been put on this both by SFM when making its investments, as well as by the WB, when qualifying the banks for the credit line, to reducing or eliminating connected lending. In order to identify irregularities in the business and spot transactions that were not made on an arms-length principle, the precondition for the investments was the full disclosure of the shareholders and their transactions. In some instances it had even led to the requirement to unwind the irregular transactions before any SFM investment could have been made. Secondly, there was improvement in strategic planning as a result of which well-articulated corporate strategies were produced. Because of the long-term nature of the SFM investment, and its intention to exit through a sale to a strategic investor, the board became much more involved in strategic issues. And last but not least, in several instances the senior management's compensation schemes were changed. Excessive bonuses--that in many cases were not even dependent on the bank's performance--were cancelled to make them consistent with the bank's objectives and long- and short-term financial results. This was not only to avoid unnecessary expenditures but above all to keep the motivation of the management in line with the objectives of the shareholders.

2.22 In addition to the areas where significant improvement had been achieved, there were also issues where progress was not so evident. There are two main reasons for this. First of all, as a financial investor with less than 10% stake in a bank, and in several cases with no other board member to support the similar objectives, it is very difficult--if not impossible--to initiate changes which require from the board both a determined and continuous effort as well as deep knowledge about banking issues. That is why in issues related to risk management the improvements were not as profound, especially in the banks where foreign shareholders had a minority of seats on the board. In instances where SFM was the only foreign member, the choice it had to make was whether to push for changes where no other board member would have an understanding of the necessity for action and as a result of that risk isolation and conflict, or keep up communication with the management and postpone the necessary changes. In several instances it was more reasonable and constructive to do the latter, and this was the route chosen by SFM in some instances.

2.23 Because of the lack of clarity in the legislation about the division of powers and duties between the management and the board, it was always an issue that was heavily debated internally, especially when drafting the by-laws of the bank. In many instances, in the first stage of development in a life of an enterprise, the shareholders are the founders of the firm and also responsible for the day-to-day management of it. In the early days of transition there was no understanding about what a board is good for and in the parliamentary discussions there was significant resistance from the entrepreneurial sector to give any real power to the board. That is why in the Commercial Codes the role of the board was defined to be very general and limited. When new outside shareholders would come in and try to change the situation, through for instance, defining the role of the board in more detail in the by-laws of the bank, there was resistance from the management which would back its arguments with the logic of the Commercial Code.

2.24 As a result of that, and despite efforts made by SFM and other similar shareholders, progress was not made in putting in place adequate internal control systems and in increasing the role of the board in the risk management of the bank. Enhancing the independence and stature of an internal audit department, and making it report directly to the board was considered by the management as a demonstration of mistrust to them and fiercely resisted. The importance of compliance procedures was not understood by the management as the enforcement powers of the supervisory agencies were weak and neither the financial risk nor the reputational risk from sanctions resulting from the violations of the laws were considered important. Because of the lack of powers and knowledge among the vast majority of members of the board, the direct involvement of the supervisory board in establishing and approving risk policies for the banks (e.g. investment and exposure limits) was never achieved. The need to establish risk management functions independent of business lines was realised only after major losses were incurred by the banks, in the aftermath of the Asian crises in 1997 and in the Russian crises in 1998.

2.25 Lack of progress in improving internal control systems and risk management in the bank should certainly not be considered a failure of SFM or other shareholders with similar mandate. The task they were facing was too difficult. However, outside support from the regulatory bodies at the stage when only financial investors are available, would have had a significant effect on what they could achieve. In Estonia, it was only after the legal framework that supports the involvement of the supervisory board was adopted that the by-

laws of the banks were changed to reflect the adequate division of powers and duties between the management and the supervisory board.⁵ The understanding about corporate governance and internal control systems among the industry itself is very low. That is why initiating discussions in the industry (e.g. banking associations) on corporate governance matters is critical to achieving implementation. One should also consider providing specific TA to the banking supervision function in corporate governance issues, so that they would be able to check if the board and the management of an individual institution has in place processes that ensure they are fulfilling all their duties and responsibilities.

⁵ In Estonia, a new law on credit institutions was passed in 1999 (effective since 01.07.1999), which devotes a full chapter on the management and organizational structure of the bank, describing *inter alia* the decision making authority of the board and management, and the rights and duties of the internal control department. With this law the powers of the board are increased and made much more explicit. Several new concepts were introduced in the law, like a four-eyes principle, conflicts of interest, etc. At the same time, the law provides each bank with significant liberty in determining what is the most suitable structure of the internal control system of each particular bank.

III. THE INGREDIENTS FOR THE SUCCESS OF A DEI

3.1 Reforming a country and building a banking sector is a complex process and it is not possible to achieve results with one magical cure. That is why the DEI, which can serve as a significant impetus to the growth and stability of the banking sector, cannot be successful if other supporting elements are not in place. Based on the experience of the Baltic countries the critical elements of a successful DEI--whichever donor were to provide it--are finding the partners to support implementation, building an appropriate organizational structure for managing the investments, and determining that the general economic conditions and the legislative environment is suitable for making the investments.

Establishing partners

3.2 Finding partners helps to avoid inefficiencies and gains synergies. There are four main types of partners that are critical to a DEI. On the one hand there is the donor country considering the establishment of a DEI. Then there is the partner embodied in other aid projects. Next are other multinational or bilateral public equity investors ready to take minority stakes in the banks. Finally there is the active involvement of host authorities that would serve to increase the impact of development work.

3.3 Investing into the banking sector when the legal environment has not been established and the economic conditions are unpredictable, is considered too risky by foreign strategic investors and, as a result, only speculative portfolio investments enter the market. Even for a country actively involved in development work, establishing a DEI would not be easy as there is a very high likelihood that the funds will be lost and / or benefit the wrong parties. Only donors from countries where a political support to the country or region has been defined internally may be willing to take that risk. The threat of being seen as intruding into another country's affairs, or as forcing its own interests on other country's banking sector, can be avoided by aligning the investments with another project coordinated by an international organization.

3.4 In many cases, because of the smallness of the banking sector, the costs of paying for an extensive due diligence would be high relative to the size of the investment. Also, knowledge of emerging markets' business practices is hard to acquire, but essential for adequately evaluating the situation in the banks. Aligning several initiatives and timing them in order to share the costs of entrance would provide a momentum for the start of the project. The WB, as one of the likely partners, is perceived to have significant knowledge in the developing economies and this would facilitate getting support to the project.

3.5 In the Baltic countries comprehensive due diligence was undertaken under the WB credit lines and the availability of qualification criteria--as well as the due diligence reports--was considered extremely valuable by SFM. The sharing of information between SFM and the special WB units continued during the lifetime of the investments. That allowed SFM to stay a small organisation with no special analytical staff. The only problem that SFM encountered when sharing the information was the timing of the equity investments versus the credit line approvals. In several cases the credit line review took longer than anticipated and if a share issue had been announced SFM was not able to wait for the final results of the

due diligence process. Unfortunately, in one of those cases the bank where SFM invested eventually did not qualify for the WB credit line and, because of the irregular transactions within that bank, SFM had to make an exit and incurred a loss.

3.6 In the Baltic projects, the DEI was combined with a credit line from the World Bank. But there are advantages and disadvantages in combining the DEI with a credit line. The advantages of the credit line have been discussed above. Based on the Baltic experience, four shortcomings can be identified. Firstly, the window of time available for the establishment of a WB credit line can be very short. In the Baltic countries, foreign private sector loans to banks came in very fast after the general legislative framework and macroeconomic stability was established. These were typically more attractive than WB credit lines. In order to meet the initial lending targets much effort went into disbursement. Or if the credit line were cancelled, the whole project could be jeopardized and the disbursement of the equity part disrupted (this did not happen in Estonia, as the credit line was cancelled after all the equity investments had been made already). The second main shortcoming is the conflict inherent in the roles of a shareholder and a lender. Funding by a shareholder (or a party linked to a shareholder) may not be on the best available terms for the borrowing bank. Need for capital may not coincide with a need for borrowed funds and excess funding with limited bankable projects may lead to unwarranted risk-taking. Thirdly, the difference in timing for the decision making for equity and lending is different, as stated earlier, causing unnecessary delays. This would be especially visible in a situation where a very rigid link is put in place between the equity and the credit line⁶. And fourthly, if a WB credit line is crowding out private credit lines⁷, some disciplining effect on the banks, which a private credit line would bring along, may be lost. Explicit loan covenants, like a right to call back money, are missing in the WB credit line and if present would be very hard to enforce for a development agency (may cause instability in the banking sector).

3.7 Finding other multinational or bilateral public sector equity investors ready to take minority stakes in the banks is important for several reasons. A public sector fund wants to avoid being seen as taking the full responsibility for the future of the bank, both for political reasons and because the allocated funds would usually not be sufficient if a serious problem rose. A small stake will be taken, which, however, makes it very difficult to enforce changes in the bank, as has been noted above. To overcome this, partners with similar views and objectives need to be sought.

3.8 Since 1995 SFM made about twenty investments and exits in Estonia, Latvia and Lithuania (see Table 1). The majority of the investments (about 3/4) had been made in the form of shares, the remainder as subordinated loans. SFM's portion of the share capital had not normally been greater than 10 %. In virtually every case the investments had been made together with international institutions or similar institutions in other EU countries. The most important co-investors had been EBRD, FMO (Netherlands), DEG

⁶ In all three countries, the project envisaged a rigid link between the credit line and the equity investment. The initial idea was to make equity funds automatically available after an approval for a credit line was achieved. This did not work out for any of the projects and the SFM was making its investments independently, but based on the information received from the WB projects.

⁷ Although in practice, WB credit lines normally offered medium to long-term maturities whereas private credit lines were typically short-term.

(Germany), Finnfund and NIB. This improved the possibility of exerting an influence through having a significant presence in the board and more voting rights at shareholder's level. The role of EBRD, which was the main partner for SFM in equity investments, should be given special attention in the region. Being the first major lender as well as an equity investor, it imposed its fairly severe conditions on the institutions it was investing in and as a result of that, helped to enhance the general banking practices in the region.

3.9 When comparing the performance of the banks where foreign investors had a significant presence in the banks (alongside SFM) and where SFM was by itself (or only together with domestic investors) the former ones have been able to demonstrate better financial results. No doubt different factors were influencing the outcome, but good risk management, as a result of imposing sound corporate governance, certainly had a significant impact.⁸

3.10 There is also potential for further increasing the development impact through making a special effort to actively involve host authorities. Valuable information is available to both sides but when not shared, the effectiveness of the work may be reduced. The experience with the Baltic projects showed that the lack of cooperation between the supervisory agency and the WB unit may cause rivalry in communicating with the banks, which is likely to undermine the position of the supervisory agency. The parties involved would usually state as a reason the strict confidentiality rules of the supervisory authority, which limit the possibility for open communication, as well as the low level of knowledge among supervisors, which makes it difficult to fully involve them. As a result, the traditional TA of supplying advisors to the supervisory agency is used. But there are training opportunities available, for example within the process of doing the due diligence and assessing the risks within the bank for the eligibility under the credit line. It could serve as a practical training in both on-site work as well as in off-site analysis. Also, the concept of connected lending and large exposures that were considered critical in assessing the suitability of banks for the credit line, were not rigorously enforced initially by the supervisory authorities. Transferring knowledge about their importance, as well as introducing the supervisory methods, would have helped to identify earlier some of the problem banks.

Building an appropriate organizational structure

3.11 Establishing an appropriate structure for managing a DEI is very important. It allows the right incentive structure to be implemented, involving the right skills. It also enables the

⁸ To illustrate this argument three banks have been compared. Eesti Uhispank (EYP), the second biggest bank in Estonia, is one of the less successful examples. The SFM initially held (at the end of 1995) a 17% share, but was gradually diluted to less than 5% (the other foreign investors were GDR holders) and its representative was the only foreigner in the board before the strategic investor had entered. The financial results of EYP have fallen below expectations, with losses both in 1998 and in 2000 (1998 EPS -1 EUR, 1999 0.2 EUR, 2000 -0.2 EUR). As a contrast to it, Vilniaus Bankas (which had already in 1996 87.5% of its shareholders foreign institutional investors and the majority of the board comprised of the representatives of foreign investors) had been profitable in the same period (1998 EPS 1.2 EUR, 1999 EPS 1.4 EUR and 2000 EPS 1.6 EUR). Unibanka showed losses in 1998 (EPS -1 EUR), due to the exposures taken to the Russian market, but since then, has been showing good results (1999 EPS 0.5 EUR, 2000 EPS 1.6 EUR). Its shareholder structure has been foreign investor dominated (over 50% owned by foreign institutional investors).

institution to be managed based on commercial principles, helping to give the investment a clear focus and ensures that the flexibility in investment decisions is maintained.

3.12 Adopting a commercial approach to the management of the DEI, and also realizing the risks of the investment, are critical in many aspects. First of all, good corporate governance can only be imposed through a profit-oriented equity investment which aims at increasing shareholder value. If investment performance is not considered important, the motives of the representatives of such as investment can be questioned by other shareholders on the board, especially when trying to adopt changes that would work in the long-term interests of all shareholders. The continuous adaptation of performance targets, protective covenants in investment contracts, as well as the involvement of high-level banking skills and flexibility in investment decisions, are some of the useful elements that can be put in place, if a commercial approach is adopted.

3.13 Setting profit targets for DEI, but balancing them with the readiness to lose the investment, is necessary is an appropriate objective. It should be stressed that no investment will take place under the difficult initial circumstances if the short-term performance measurement starts to dominate development goals. On the other hand, the investment needs to be reviewed on a regular basis and the objectives and the Return on Equity (ROE) targets should be changed during the project in order to increase discipline and avoid unnecessary losses. If stability is achieved, there is no reason to keep the ROE targets low or undetermined. Performance targets also help to neutralize pressures from the recipient country's authorities to have the DEI investor act as an "investor of last resort", saving them from the embarrassment caused by a bank failure.

3.14 In the case of the Baltic experience, the Government of Sweden wanted, as far as was possible, to receive a reasonable return but realized that risk capital in its true sense was involved. The support element was in making funds available at a time when the market could not help. The contribution was to be for a limited period accompanied by a requirement for insight and inspection. The management of the fund was supposed to be undertaken by a body with professional banking skills, which could act independently. The fund was established as a subsidiary company under Swedfund International with its own board. Its financial results were published in the annual report of Swedfund International. The financial performance of SFM exceeded an expectations (see Box 3).

Box 3. Swedfund Financial Markets AB

Swedfund Financial Markets (SFM) was established as a wholly-owned subsidiary company of Swedfund International AB, which is a state owned risk capital company providing capital and know-how for investments in the developing countries. The company was commissioned by the Swedish Government to contribute to the development of the financial sector in the Baltic states by providing capital and know-how. For this purpose the Government of Sweden made available a sum of SEK 240 million. During its operations SFM had an average of two employees. Administrative and legal services were offered by the parent company. SFM had its own Board of Directors and the Managing Director was a banker with extensive commercial banking experience.

At the end of 1996 SFM had invested SEK 155.2 million in twelve banks in the three Baltic countries. No write-downs or sales were made during the financial year. The year's result was a loss of SEK 272 932. This result included costs of technical cooperation amounting to SEK 3.5 million.

At the end of 1997, the SFM portfolio at book value was SEK 199 million. During the year, two equity investments had been divested. SEK 1.6 million of an equity investment had been written down. The financial year's profit was SEK 11 million, which had been charged with a SEK 1.6 million costs for technical assistance.

At the end of 1998 the book value of the investments had fallen to SEK 187.5 million. During the year, holdings in three banks had been sold. An equity investment and a subordinated loan totalling SEK 27.3 million had been written off in its entirety. Three other equity investments and the interests on loans had been written down by SEK 16.4 million to market value, all due to the impact of the Russian financial crises on the region.

1999 was a successful year for SFM. Shares in two banks were sold and the book value of the remaining investments (five equity investments and four subordinated loans) was SEK 171 million. The profit for the financial year was SEK 40 million.

Year 2000 was the year when all the remaining investments had been sold. The profit made for the financial year was SEK 188 million. Despite the losses in 1998, the average annual ROE was 15%.

3.15 Often private investors, when they enter into a lending agreement with a bank from an emerging market, prescribe specific performance targets and reporting routines. With equity investments, restrictions are imposed on the management in their business decisions (e.g. exposure limits), and a board membership is required. Such conditions can have a beneficial effect as they are often stricter than those prescribed by law and support the efforts of the supervisory agency. SFM did not have any special requirements, other than the board membership. If a DEI were to be replicated in the future, consideration should be given to taking more rights. A DEI might have somewhat more flexibility than for instance EBRD or IFC with their very standardized contracts and can tailor the requirements to address the specific needs of a particular market. Too few requirements by a DEI can make it more favored by the banks at the expense of other multinational organizations. As a result an opportunity to impose market discipline is missed.

3.16 Involving high quality banking skills to manage the investment is critical if a commercial approach to a DEI is adopted. This may not necessarily be the case with aid projects, as they are usually managed by people with very good experience in development work, but with only some financial sector exposure. Participating in a bank's board, with an objective to implement corporate governance, requires solid banking experience. Good insight is needed for the investment decisions, for surfacing connected lending and large

exposures, for assessing the level of professionalism, and for detecting corruption in the management.

3.17 Considerable flexibility in the investment guidelines (i.e. exposure limits and diversification requirements) is needed for a DEI. Only after due diligence can suitable banks be identified, the number of which may turn out to be much smaller than initially envisaged, making diversification hard to achieve. Fine-tuning is necessary to find a right balance between focus and diversification, as investing in several banks within a competitive market may cause tension, raising concerns about confidentiality and conflicts of interest issues. Concentrating on few institutions would permit the DEI to make a bigger and more sustainable impact. Often banks with foreign investments develop into leading institutions in the market, as they have the benefit of adequate capitalisation and access to funding. When there are other international financial institutions already present in the market, a DEI could invest in a bank which perhaps has not received a foreign investment yet. This would facilitate increased competition and a more balanced and diverse banking market. On the other hand, when investments are made in several banks in a transition country, the much needed consolidation process can be supported or even initiated. This way a DEI can play an important role in shaping the banking market.

3.18 SFM made about twenty investments in Estonia, Latvia and Lithuania (see Table 1). Equity was invested in three banks in Estonia, four banks in Latvia and four banks in Lithuania. In Estonia, out of the three investments two were divested within about a year, leaving SFM with one major investment in the country. Both in Latvia and Lithuania, one bank was divested in the first year and holdings were kept for at least two years or longer in three remaining banks. Also in both countries two of the banks, where the SFM had made the investments, subsequently merged. SFM had also taken steps to institute regional co-operation between the banks, thus facilitating the entrance of strategic investors.⁹ When SFM was making its investments in the banking sector, it was well aware of the potential conflict of interest and made sure that the same person was not representing SFM in different banks in the same market. That considerably reduced anxiety among the banks, as it was taken as a demonstration of good intentions.

3.19 When planning a DEI, the project should not be overburdened with several objectives. Often there are high expectations from both the partners (i.e. other donors providing TA to that particular region) as well as the recipient country. Accordingly the DEI can be made responsible for delivering and coordinating TA to the individual institutions. Instead, a DEI should primarily be used for supporting at the board level the TA provided by other institutions. This would not divert its focus from corporate governance work, an area that can be effectively addressed only from within an institution.

⁹ In 1998, Swedish Skandinaviska Enskilda Banken bought a controlling stake in Vilniaus Bank, Unibank and Eesti Uhispank. The three banks had entered into a partnership agreement the previous year with an objective to support each others clients with offering banking services. Such cooperation helped them avoid inefficient expansion costs which would have otherwise been made in order to acquire a pan-Baltic presence.

Investments (mln SEK)	Acquisition Value & Date	Sale Value & Exit Date	Co-financier/final investor
ESTONIA			
Tallinna Pank	6.5 (1995)	21.5 (1997)	Co-investor FMO, Exit to market
Estonian Investment Bank	8.7 (1997)	19.1 (1998)	EBRD, DEG, Finnfund, sale to management
Uhispank	40.7 (1995, 1997)	66.2 (2000)	Sale to SEB
LATVIA			
Latvian Investment Bank	6.9 (1997)	10.2 (1997)	EBRD, DEG, Finnfund, sale to Finnfund
Latvijas Zemes Banka	7.4 (1996)	8.2 (1998)	EBRD, sale to Hoiupank
Unibanka	47.6 (1996, 1998)	94.5 (2000)	EBRD, sale to SEB
Riga Commercial Bank	18.5 (1996)	0.3 (2000)	EBRD, sale to Norddeutsche Landesbank
LITHUANIA			
Lithuanian Development Bank	10.1 (1997)	10.5 (1998)	EBRD, DEG, NIB, sale to NIB
Bankas Hermis	22.1 (1997)	42.2 (2000)	EBRD, sale to Vilniaus Banka
UKIO Bankas	6.8 (1997)	4.1 (1999)	Exit to market
Vilniaus Bankas	17.7 (1995, 1996)	124.3 (2000)	DEG, sale to SEB
SUBORDINATED LOANS (mln SEK)			
Hansapank	13.5		Taken over from Hoiupank, fully repaid
Uhispank	9.0		Taken over from Tallinna Pank, fully repaid
Maapank	9.0		EBRD co-investor, written off
Vilniaus Bankas	40.0		Fully repaid

3.20 Special caution is necessary with the expectations the host financial authorities may have in the case of the emergence of financial distress in a bank. Competence to initiate major restructuring is not necessarily available in a DEI and that is why investments should not be made into ailing institutions, which might rely on a DEI to provide them with a recovery plan. Also, if problems arise during the time the DEI has been made, the authorities should not expect a DEI to bail out the bank or to take a lead in restructuring efforts.

Determining an adequate environment for investment

3.21 It is not easy to determine the right environment and preconditions for a DEI project. At minimum, one would look for general political stability and commitment to reforms and fiscal discipline. The privatisation of small and medium sized enterprises should also have been started and the legal acts providing protection to property rights need to be in place. For the banking specific environment, the development of a modern banking law has to be progressing and an accounting law in line with international standards has to be passed or be under preparation. The independent auditing profession has to be established and the banking supervision function should have adequate powers and independence to act.

3.22 One needs to be careful, though, not to overemphasize the progress that has to be achieved by the time an investment is made. For the Baltic projects, several preconditions had been set. But even when not all the initially envisaged reforms had been fully implemented, the project still proceeded further in order not to lose the development effect of an equity investment. A delay might have also resulted in losing the development momentum in the banking sector, thereby making the whole reform process more costly and less efficient.

3.23 In hindsight, when analyzing the Baltic experience, the conditions appear to have been suitable for a development oriented equity project. Firstly, modern company and banking laws, providing a basis for imposing corporate governance and the enforcement of shareholder rights, had been, or were in the process of being passed. Secondly, the countries had demonstrated their commitment towards macroeconomic stability, which provided the necessary confidence among the entrepreneurial community for the initiation of long-term investment projects after profit opportunities from large-scale price distortions vanished. Thirdly, the privatization of the small and medium-sized enterprises had been mostly completed. And, fourthly, despite the fact that the whole banking sector was not yet in the private hands, there was a significant number of private banks operating without public subsidies and interference. These four factors together provided the legal security, demand for traditional banking products, as well as the necessary clients and providers of such products. Additional benefits were incurred from areas like bankruptcy laws, which imposed a necessary discipline on the enterprises in payments (from mortgage and collateral laws). This served as a guarantee to the enforcement of claims against defaulting borrowers as well as from ownership registers, which help provide assurance about property rights.

3.24 The timing of DEI investments is of critical importance. In countries where domestic capital accumulation is poor because of low domestic savings mobilization, foreign investments have a big catalytic role to play. Reforming countries with bigger economies are in a better position to attract foreign investments, as the size of future revenues cover the

transaction costs. In the case of smaller countries, it is a serious challenge to attract strategic investors, especially to the banking sector.

3.25 In the Baltic countries extensive TA had been provided and, as a result, by 1996 the main legal acts like commercial and central banking laws, laws on accounting, etc. were in place¹⁰. But long-term foreign investors also need confidence that the regulations are followed by the business community and that the authorities are consistently enforcing them. In order to be convinced of it, a track record of several years is needed. This is when a DEI, which is initiated in parallel with the TA projects, can make a sustainable impact. This can be followed at a later stage by the DEI being a counterpart to a potential strategic investor in the discussion of the future investments¹¹.

3.26 The entrance of foreign strategic investors into the Baltic banking market by DEI was well timed. However a question had been raised, especially for Estonia, whether it had been too late, as the credit line, which was a part of the project, was not fully disbursed and the market developed so fast that there were plenty of funds available from private sources. But in Estonia, as well as in Latvia and Lithuania--even for leading institutions--credit funds from private sources became available much earlier than equity investments. Strategic investments into the banking sector did not come before 1998, indicating that the environment was considered too unstable for private long-term equity. Short-term financial investment were available (GDR issues and local stock exchange listings were initiated by major banks in all three countries starting as early as in 1996), but were very volatile in nature, especially in a context where there were no capital controls and a readily available exit mechanism through the stock market.

¹⁰ Several improvements were made in the later years to bring the legislation into full conformity with the EU directives. In some instances, like in the case of Estonia, it resulted in the full rewriting of the Law on Credit Institutions (became effective in 1999).

¹¹ In the case of the Baltic projects the presence of SFM supported the entrance of Swedish investors and helped them make decisions faster. In 1998, after the August 1998 Russian crises, Skandinaviska Enskilda Banken (SEB) from Sweden acquired a strategic stake in three commercial banks in each Baltic state. Since the acquisition, they have continuously increased their share in the banks' share capital. By 2000, over 95% of the shares have been acquired by SEB in each of these banks.

IV. CONCLUSION

4.1 The analysis of the World Bank and the Government of Sweden joint assistance projects clearly demonstrates that a DEI is an effective instrument for providing support in emerging countries with a shortage of capital and banking expertise. The possibility to impose sound corporate governance on the emerging banking institutions through a DEI can significantly enhance the quality of the banking sector. The analysis undertaken within the framework of this study has shown that the level of banking skills-- because of the structure of the industry itself, as well as its shareholders and board members-- is very low in the starting years. The initial character of the banking business, specifically undertaking trade finance instead of project finance, does not provide much of a learning experience in real banking and as a result serious problems may grow on the books of the commercial banks. The inadequacy of loan loss provisioning and other undisclosed risks (which result from imprudent risk-taking possible due to poor banking regulation and the lack of management information systems) would lead to a situation in which the level of capitalization cannot be sufficient to absorb future losses. Unfortunately, often none of this is understood either by the financial authorities or the public, partly also because of the poor quality of auditing work.

4.2 There is no doubt that the TA work undertaken in the Baltic countries had a significant impact in correcting some of the shortcomings. TA to government has been helpful in establishing a regulatory environment. In the case of the World Bank projects, direct TA to the banks had been a major success, as substantial and effective work was done through the Bank's special units within the framework of the credit lines.

4.3 But in addition to the success, there are also areas where the TA cannot have sufficient impact. The key challenge is in changing business practices. TA to the banking supervision function does not provide immediate results as it takes a long time to train a supervisor and generate the trust and respect of the banking industry. The only way to make a sustainable impact, and achieve a change in business practices, is through sound corporate governance imposed by the shareholders from within the institutions. The analysis of the Baltic countries showed that despite the good intentions and much effort there are several areas where changes are very hard to enforce when a shareholder would have a minority. The case of SFM can be used to illustrate this argument. Despite the difficulties, progress was made with improving transparency, communication with shareholders, and in managing conflict of interest situations. But more progress would have been achieved if corporate governance, as an instrument to initiate changes, had been recognized also by other parties.

4.4 The SFM experience also highlighted several areas that would be critical in achieving success with a DEI. Above all, it is the choice of right partners. A suitable donor for a DEI is a country with political support and strategic interest in the region. Partnering with other aid programs helps to decrease transaction costs. In addition, other multinational or bilateral public equity investors ready to take minority stakes are needed, as it is very difficult, if not impossible, to initiate changes with having a minority stake. And it would also be helpful to pay special attention to communication with host authorities to increase support and pursue development objective, as there are several learning opportunities during such complex aid projects.

4.5 Building an appropriate organizational structure is important in order to adopt a commercial approach. The SFM project is a good example where a return was expected but the riskiness of the investment was fully understood by the government. With profit targets tougher covenants in investment contracts are imposed, which helps to introduce corporate governance in situations when management is not cooperating. It also helps to bring on board high-level banking skills, which are the only way to spot fraud and impose effective board supervision. At the same time maintaining flexibility in investment decisions is important, as it can have a powerful effect on the way the banking market is developing. Providing a clear focus through not getting involved in TA, but instead using corporate governance for achieving development objectives, is critical in achieving better results. As a result, the financial results of SFM were much better than initially expected.

4.6 The issue of what is the right environment for a DEI, and what is the most appropriate time for the investment, is not an easy one. Having the basic regulations in place is necessary, but waiting too long may result in losing the development momentum. The Baltic environment and timing seemed to have been right, as was also proven by the time the foreign investors actually entered the market. The SFM was able to divest its investments and declare its goals in the Baltic banking sector fulfilled.

References

- Staff Appraisal Report, Financial Institution Development Project, Estonia, September 15, 1994
- Staff Appraisal Report, Enterprise and Financial Sector Restructuring Project, Republic of Latvia, August 16, 1994
- Staff Appraisal Report, Enterprise and Financial Sector Assistance Project, Republic of Lithuania, March 27, 1995
- Implementation Completion Report, Financial Institution Development Project, Estonia, November 30, 1998
- Implementation Completion Report on a Single Currency and Currency Pool Loan in the Amount of US\$10, DM 8.5, and US\$20 Million to the Republic of Latvia for and Enterprise and Financial Sector Restructuring Project, March 14, 2000
- Implementation Completion Report, Enterprise and Financial Sector Assistance Project, Republic of Lithuania, February 6, 2001
- Annual Reports 1996 – 2000, Eesti Uhispank
- Annual Reports 1996 – 2000, Latvijas Unibanka
- Annual Reports 1996 – 2000, Vilniaus Bankas
- Annual Reports, 1995/96 – 1999, Swedfund International AB
- OECD Principles of Corporate Governance, Meeting of the OECD Council at Ministerial Level, 1999
- Enhancing Corporate Governance for Banking Organisations, The Basle Committee on Banking Supervision, 2000
- Core Principles for Effective Banking Supervision, The Basle Committee on Banking Supervision, 1997

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS2706	Household Income Dynamics in Rural China	Jyotsna Jalan Martin Ravallion	November 2001	C. Cunanan 32301
WPS2707	Financial Intermediary Development and Growth Volatility: Do Intermediaries Dampen or Magnify Shocks?	Thorsten Beck Mattias Lundberg Giovanni Majnoni	November 2001	A. Yaptenco 38526
WPS2708	Accountability and Corruption: Political Institutions Matter	Daniel Lederman Norman Loayza Rodrigo Reis Soares	November 2001	P. Soto 37892
WPS2709	Explaining Leakage of Public Funds	Ritva Reinikka Jakob Svensson	November 2001	H. Sladovich 37698
WPS2710	Breaking up the Collective Farm: Welfare Outcomes of Vietnam's Massive Land Privatization	Martin Ravallion Dominique van de Walle	November 2001	C. Cunanan 32301
WPS2711	Identifying Class Size Effects in Developing Countries: Evidence from Rural Schools in Bolivia	Miguel Urquiola	November 2001	H. Sladovich 37698
WPS2712	Contract Risks and Credit Spread Determinants in the International Project Bond Market	Mansoor Dailami Robert Hauswald	November 2001	W. Nedrow 31585
WPS2713	Causes of Inequality in Health: Who You Are? Where You Live? Or Who Your Parents Were?	Adam Wagstaff Pierella Paci Heather Joshi	November 2001	H. Sladovich 37698
WPS2714	On Decomposing the Causes of Health Sector Inequalities with an Application to Malnutrition Inequalities in Vietnam	Adam Wagstaff Eddy van Doorslaer Naoko Watanabe	November 2001	H. Sladovich 37698
WPS2715	Paying for Health Care: Quantifying Fairness, Catastrophe, and Impoverishment, with Applications to Vietnam, 1993–98	Adam Wagstaff Eddy van Doorslaer	November 2001	H. Sladovich 37698
WPS2716	Does Foreign Bank Penetration Reduce Access to Credit in Developing Countries? Evidence from Asking Borrowers	George R. G. Clarke Robert Cull Maria Soledad Martinez Peria	November 2001	P. Sintim-Aboagye 37644

Policy Research Working Paper Series

	Title	Author	Date	Contact for paper
WPS2717	Bridging the Economic Divide within Nations: A Scorecard on the Performance of Regional Development Policies in Reducing Regional Income Disparities	Raja Shankar Anwar Shah	November 2001	A. Santos 31675
WPS2718	Liberalizing Basic Telecommunications: The Asian Experience	Carsten Fink Aaditya Mattoo Randeep Rathindran	November 2001	R. Simms 37156
WPS2719	Is There a Positive Incentive Effect from Privatizing Social Security? Evidence from Latin America	Truman G. Packard	November 2001	T. Packard 89078
WPS2720	International Migration and the Global Economic Order: An Overview	Andres Solimano	November 2001	A. Bonfield 31248
WPS2721	Implications for South Asian Countries of Abolishing the Multifibre Arrangement	Sanjay Kathuria Will Martin Anjali Bhardwaj	November 2001	M. Kasilag 39081
WPS2722	Japan's Official Development Assistance: Recent Issues and Future Directions	Masahiro Kawai Shinji Takagi	November 2001	J. Mendrofa 81885